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SUBJECT: PRESIDENT KOCHARIAN: 2005 TO BE THE YEAR OF TAX AND CUSTOMS REFORMS

Ref: 04 YEREVAN 1899

1. SENSITIVE BUT UNCLASSIFIED. PLEASE PROTECT ACCORDINGLY.
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SUMMARY

2. (SBU) Armenia's President Robert Kocharian has publicly said that 2005 will be a year of reform for the customs and tax services in Armenia. Besides increasing tax revenues, Kocharian called on the revenue services to "act legally" and not to create "privileged conditions for anybody." In these words Kocharian acknowledged the dominant concern of the Armenian economy and perhaps the heaviest burden on small and medium enterprise development. Armenia's revenue services systematically either fail to tax or undertax Armenia's oligarchs, and systematically overtax medium-sized and foreign firms to compensate. Besides limiting tax revenues, this has created virtual monopolies for favored oligarchs in various basic sectors where competition should be stronger. Reform of the revenue services will damage entrenched interests of powerful people, and will require political will at the highest levels of Armenian government. End Summary.

KOCHARIAN SAYING THE RIGHT THINGS

3. (SBU) In his January 11 address to the State Customs Committee, Kocharian clearly laid out the problem of corruption in the revenue services, echoing what the international business community, the International Monetary Fund and we have been saying for years. Along with addressing the longer-term task of increasing revenue, Kocharian acknowledged corruption and nepotism in the customs service, and said that it must change to treat all businesses "equally and fairly." "I am sure that if you start from yourself, from taxing your friends and relatives, you will not let others escape taxation either," Kocharian said, according to his own press office web site, "We cannot forbid your friends from doing business. We encourage free enterprise. What we don't encourage is the creation of privileged conditions for anybody." Kocharian made a similar address to the tax service officials the next day, saying, "There are enterprises which have not been inspected for years and those which are inspected several times every year."

TAX AND CUSTOMS: TOOLS OF THE OLIGARCHS

4. (SBU) The tax and customs services have long been tools of the oligarchs. Rather than following Armenian law and WTO procedures on customs valuation, the customs service has used different valuations for different importers, often resulting in a laughably low tariff burden for favored importers and a prohibitively high tariff burden for new market entrants (reftel). The result has been virtual monopolies on the import of several basic goods such as wheat, sugar, tobacco, salt, beer, gasoline, for which there is no economic justification for a natural monopoly or lack of competition.

5. (SBU) Similarly, the tax service has failed to enforce tax provision against some of Armenia's largest businesses. Kotayk Beer, owned by Armenia's most ostentatious oligarch and Deputy of Parliament Gagik Tsarukian (aka Dodi Gago) is indisputably Armenia's largest beer company. Nevertheless, it does not appear on the list of Armenia's large taxpayers despite the fact that Kilikia, its weaker competitor is one of the top ten taxpayers. Small and medium-sized enterprises, on the other hand, complain of overtaxation. Members of the Yerevan American Chamber of Commerce complain of harassing and unjustifiable tax inspections, illegal demands for prepayment of tax liability, and the failure of the Armenian government to refund tax overpayments for several years.

CONSTANT PRESSURE OF INTERNATIONAL COMMUNITY

16. (SBU) Corruption in the tax and customs services has come under increasing pressure from the international donor community in the past two years. The American Chamber of Commerce has raised it to the Prime Minister, the chair of the High Business Council. The IMF has made tax and customs reforms conditionalities in its reviews of Armenia's PRGF arrangement, and we have raised concerns about tax and customs consistently at the US-Armenia Task Force (USATF).

17. (SBU) Speaking about the possibility of a new Poverty Reduction and Growth Facility (PRGF) arrangement, IMF resident representative James McHugh told us that the government has completed all the reforms that are politically easy to complete. (Note: The last tranche of the last PRGF arrangement was disbursed in November 2004. End Note.) "The question we are asking them now is," said McHugh, "are they willing to tax rich people." The international community has constantly emphasized the need for reform of the tax and customs administration in order to create a competitive business environment and to increase overall tax revenues, which is necessary to meet the social demands called for in Armenia's Poverty Reduction Strategy Paper. (Note: At 15 percent of GDP, Armenia's tax base is the lowest in the CIS. End Note.)

18. (SBU) In a November letter to the IMF asking for a follow-on PRGF arrangement, the Minister of Finance and the Prime Minister promised reforms of the two revenue services, specifically promising to bring them under the control of the Minister of Finance. To move revenue collection and expenditure under the same roof could be a boon for the Armenian economy, but it will take the support of Armenia's highest officials to effect.

COMMENT: EASIER SAID THAN DONE

19. (SBU) We welcome President Kocharian's comments about reforms in the tax and customs service, but are skeptical of the President's will and, even, ability to push them through. Reform of these two agencies will require breaking down entrenched interests in nepotism and corruption, and replacing powerful officials who have close ties to the President and Minister of Defense. Although some GOAM officials recognize the need for reform, we don't think that they have the power to change the leadership or practices of the powerful revenue services. In the past, our demands (and those of other donors) for reforms in the revenue services have been received positively by the Minister of Finance, but shrugged off by the heads of tax and customs. At the May 2004 USATF in Yerevan, the point about illegal customs valuation created a publicly awkward moment between Armenia's Minister of Finance and General Avetissian, the Head of the Customs Service, where the General suggested that he does not report to the Minister. Now that Kocharian has stated the problem and the direction of reform, what progress he makes will be a test of Armenia's political will to move from familiar ways of nepotism and corruption to a true market economy.

EVANS